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OCTOBER TERM, 1969

THE NEW HAVEN INCLUSION CASES

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK AND ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF OF APPELLEE — RESPONDENT, RICHARD JOYCE SMITH, TRUSTEE, IN SUPPORT OF APPELLANTS — PETITIONERS

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March 25, 1970

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INTRODUCTION

This reply to the government (the United States and the Interstate Commerce Commission) and Penn Central is essentially confined to what now clearly appears from their briefs to be a central, if not the predominant, issue in these cases.[1] As put by the government, "the only issue is whether, under conventional standards of judicial review of agency action, the Commission's determinations of net liquidation value as of December 31, 1966, and the value

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[1] Abbreviations and short references employed in the Trustee's main brief dated February 25, 1970 will also be employed in this reply brief; in addition, the brief of the United States and the Interstate Commerce Commission dated March 1970 will be referred to as "U.S. Br." and the brief of Penn Central Transportation Company dated March 18, 1970 will be referred to as "P.C. Br." We have noted, and consider that it should be brought to the Court's attention, that the petition for certioriari in No. 1038 was filed by Penn Central Company rather than Penn Central Transportation Company, which filed the brief herein.

of the consideration to be given by Penn Central were rational and supported by substantial evidence" (U.S. Br. 27). Similarly, Penn Central states that "the ultimate issue here is whether the Commission's evaluation of the New Haven's properties has a reasonable basis in findings that are supported by substantial evidence" (P.C. Br. 15).

In thus stating the issue, both the government and Penn Central insist that the Reorganization Court failed to adhere to proper standards of judicial review and improperly substituted its judgment for that of the Commission on valuation issues (U.S. Br. 27; P.C. Br. 15).

It is, we consider, a fair comment on the briefs of both the government and Penn Central that neither attempts to argue what the consequences of their position as to the factual issues would be if they should be wrong in their position with respect to the applicability of the substantial evidence rule to the hearing by the Reorganization Court required by §77(e) of the Bankruptcy Act. For the reasons stated in his main brief, the Trustee considers that the Reorganization Court's disagreements with the Commission should be sustained even when viewed in terms of the substantial evidence rule. But, the Trustee further submits that the substantial evidence rule in the form relied upon by the government and Penn Central is not so applicable to the Reorganization Court, and that, therefore, every determination of the Reorganization Court which is being attacked by the government and Penn Central must, in any event, be sustained.

According to the government, its position is bottomed on three "basic propositions of law that govern these cases," as to which it believes "there can be no serious disagreement" (U.S. Br. 26). In fact, the Trustee strongly disagrees with one of those propositions. The Trustee is willing to accept, *arguendo*, under the circumstances of this case, the first two propositions, *i.e.*, that the Commission's roles

under both the Bankruptcy Act and the Interstate Commerce Act are the same insofar as determining an appropriate price is concerned; and that the "fair and equitable" standard of §77(e) on the one hand and the "just and reasonable" and "equitable" standards of §5(2) of the Interstate Commerce Act on the other may be treated as embodying the same statutory considerations.[2] However, the Trustee wholly disagrees "that the scope of judicial review under the two statutory schemes is the same," whether this be deemed a basic proposition of law or otherwise (U.S. Br. 26-27).

As hereinafter shown, the Trustee considers that the scope of review by the Reorganization Court under §77(e) is not limited to the conventional application of the substantial evidence rule which clearly governs review of traditional and usual orders of administrative agencies.

The substantial evidence rule is applicable only in those situations, unlike that presented by §77(e), where admission of new evidence by the reviewing court should be barred. In the case of §77, however, the Court provided in *Ecker* v. *Western Pacific R. Corp.*, 318 U.S. 448, 477 (1943) that a reorganization court could receive "such additional evidence as may be pertinent to the objections to the Commission's finding of value." The functions of the reorganization court which were prescribed by the Court in the *Ecker* case have a unique foundation in the Bankruptcy Act, resulting from the special position of the Commission under §77 and the nature of the findings required to be made by the reorganization court following its own independent hearing.

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[2]This assumption, however, must properly take into account *Otis & Co.* v. *Securities and Exchange Commission*, 323 U.S. 624 (1945), in which the bankruptcy law meaning of "fair and equitable" was not applied in a reorganization under the Public Utility Holding Company Act of 1935.

The Trustee submits, furthermore, that the Reorganization Court properly carried out the scope of review assigned to it by the *Ecker* case, and that there is no legal or public policy reason why the Court should find that there is a need or requirement for an identical scope of review under the Bankruptcy Act and under the Interstate Commerce Act of an order of the Commission entered under both Acts.

ARGUMENT

I. THE SCOPE OF REVIEW BY THE REORGANIZATION COURT UNDER §77(e) OF THE BANKRUPTCY ACT IS NOT LIMITED BY THE "SUBSTANTIAL EVIDENCE" RULE.

The government and Penn Central offer no authority, except *Ecker* and similar cases, for their contention that a reorganization court is bound by the substantial evidence rule in carrying out its functions under §77(e). It is significant in this respect that the *Ecker* case does not itself at any point refer to the applicability of what was at its date of decision a long established rule of review based upon "substantial evidence." To be sure, the Court there spoke of a reorganization court's examination as being for the purpose of ascertaining whether the Commission's determination was "reached with material evidence" (*Id.* at 473). It is unnecessary, however, to consider whether "material" and "substantial" mean the same thing in a scope of review context, since the Court went on specifically to prescribe the scope of a reorganization court's review function. It stated that a reorganization court "shall be satisfied, upon the record before the Commission, *with such additional evidence as may be pertinent to the objections to the Commission's finding of value,* that the statutory requirements have been followed" (*Id.* at 477, emphasis added). The Trustee submits that this direction to the reorganization court not only is not the "substantial evidence" rule but, on the contrary, is the prescription of a unique rule for a unique situation.

a. The substantial evidence rule is applicable only where, unlike §77(e), the admission of evidence by the reviewing court is barred.

A principal reason for adoption of the substantial evidence rule was to avoid "needless duplication of evidentiary hearings and a heavy additional burden in the time and expense required to bring litigation to an end." See *United States* v. *Bianchi & Co.*, 373 U.S. 709, 717 (1963). As Mr. Justice Harlan there stated (*Id.* at 715):

> "The term 'substantial evidence' in particular has become a term of art to describe the basis on which an administrative record is to be judged by a reviewing court. This standard goes to the reasonableness of what the agency did *on the basis of the evidence before it*, for a decision may be supported by substantial evidence even though it could be refuted by other evidence that was not presented to the decision-making body." (Emphasis in original).[3]

The holding of the *Bianchi* case that the reviewing court could not admit evidence has a well-established background. Mr. Justice Brandeis, for instance, pointed out in *Louisville and Nashville R. Co.* v. *United States*, 245 U.S. 463, 466 (1918) that the validity of an order of the Interstate Commerce Commission was required to be determined "upon the evidence introduced before the Commission;" and in *Tagg Bros. & Moorhead* v. *United States*, 280 U.S. 420, 443 (1930), he stated that the proceeding there involved was "a judicial review, not a trial de novo," noting that an order of the Secretary of Agriculture "like that of an order of the Interstate Commerce Commission, must be

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[3] Mr. Justice Douglas, with whom Mr. Justice Stewart concurred, dissented in the *Bianchi* case, but not on the ground of the definition of the substantial evidence rule. He considered that the agency decision was "capricious or arbitrary", and that a de novo hearing by the Court of Claims, which had been the reviewing court, was permissible.

determined upon the record of the proceedings before him — save as there may be an exception of issues presenting claims of constitutional right."

The Trustee submits, accordingly, that the Court's express recognition in the *Ecker* case that a reorganization court's function includes the taking of additional evidence clearly distinguishes it from the type of review required by the substantial evidence rule as described in the *Bianchi* case. The unique relationships of a reorganization court and the Commission under §77 of the Bankruptcy Act provide overwhelming reason for the Court to decide as it did in the *Ecker* case.

b. The review functions assigned to the Reorganization Court by the *Ecker* case have a unique foundation.

Unlike conventional review of the acts or decisions of an administrative agency by an appellate court (whether a three-judge court or a court of appeals), there is a unique relationship between court and administrative agency created by §77 of the Bankruptcy Act. As Mr. Justice Frankfurter put it, "the authority of the [Reorganization] Court is intertwined with that of the Commission." *Palmer* v. *Massachusetts*, 308 U.S. 79, 87 (1939).

The significance of this relationship was referred to by Mr. Justice Douglas in *St. Joe Paper Co.* v. *Atlantic C. L. R. Co.*, 347 U.S. 298, 322 (1954).[4] He there stated:

> "To understand the issue in these cases it is necessary to have an understanding of the respective functions of the Commission and the reorganization court under §77.

[4] Mr. Justice Douglas dissented in the case, but the Trustee considers that references to the case in this brief do not involve the question upon which the dissent was taken.

"*First.* Under §77 the Commission is the chief architect of any plan of reorganization.[5] The plan must originate with the Commission. §77(d). *Second.* Once a plan is certified by the Commission it goes to the Court for a hearing. §77(e)."

Penn Central argues that the legislative history of §77 demonstrates that valuation determinations which are to be made by the Commission are "subject to limited judicial review" (P.C. Br. 5b; see P.C. Br. 21). To be sure, the legislative history is wholly consistent with Mr. Justice Douglas' characterization of the Commission as the "chief architect" of a plan under §77. It does not follow, however, that the limitation to be placed upon judicial review consistent with this role of the Commission requires imposition of the substantial evidence rule. On the contrary, the very fact that the Commission's findings constitute its approval of its own design as "chief architect" strongly demands an independent, unfettered judicial review. It is clear in the portions of legislative history set forth in detail by Penn Central in its brief, that there is no statement *in haec verba* by the Congress that a reorganization court is intended to be governed by the substantial evidence rule.[6] In light of the Commission's intimate relationship with a plan of reorganization and the actual provisions of §77, it is a reasonable conclusion that, however the scope of review of the reorganization court may fairly be limited, it is not limited by the substantial evidence rule.

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[5] Judge Friendly quoted this description of the Commission's function with approval in *In re New York, New Haven and Hartford R. Co.*, 378 F. 2d 635, 639 (1967), which dealt with a related question not in issue in the cases now before the Court.

[6] The legislative history referred to by Penn Central occurred in 1935; the traditional limitation on scope of review of an order of the Commission was noted by the Court as early as 1918 in *Louisville & Nashville R. Co., supra,* at 466 and must be assumed to have been known to the Congress if it wished specifically to adopt it or even refer to it.

The "hearing" before the reorganization court referred to by Mr. Justice Douglas as the second step in carrying out the respective functions is an actual quotation from the statute. The second sentence of §77(e) requires, after a plan has been certified by the Commission to the reorganization court, that the judge give notice and hear all parties and all "claims for equitable treatment." The third sentence provides that "after such hearing," the judge shall approve the plan if he is satisfied, among other things, that it is "fair and equitable." These are not customary or conventional provisions for review which demand, as a matter of administrative law, the application of the substantial evidence rule. These provisions contemplate that the judge shall himself determine how he shall conduct a hearing and to what extent he shall receive evidence. This conclusion is wholly buttressed by the provision in §77(e) describing what the judge must do if, as is the actual case here, he disapproves the plan. The first sentence of the second paragraph of §77(e) provides in that instance that the judge may either dismiss the proceedings or, at his discretion, refer the proceedings back to the Commission for further action, "in which event he shall submit to the Commission a copy of any evidence received."

The only reasonable interpretation of these hearing and evidentiary references in §77(e) is that the judge is entitled to conduct even the equivalent of a trial de novo if, in his discretion, he deems it necessary and, further, notwithstanding any position taken by the Commission at the hearing or otherwise, he has the discretion to dismiss the entire proceeding.[7] The government and Penn Central may argue that this conclusion is inconsistent with the last paragraph

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[7]The Commission has indicated its awareness of the independent nature of the reorganization court's function under §77(e). In conditioning the Penn Central merger upon inclusion of the New Haven's operations, it specifically provided that terms of inclusion shall be "subject to approval by the Bankruptcy Court." *Pennsylvania R. Co.—Merger — New York Central R. Co.*, 327 I.C.C. 475, 553 (1966).

of §77(e), which provides that the Commission shall "determine the value of any property for any purpose." It is submitted, however, that there is no fundamental inconsistency in view of the Court's direction to the reorganization court in the *Ecker* case. The Commission is charged with carrying out the valuation function without the necessity of approval by the reorganization court (*Ecker*, at 472). Thereafter, upon receiving such evidence as he considers appropriate with respect to whether that function was properly carried out, *i.e.*, that it was supported by "material evidence" (*Id.* at 473) and the statutory requirements have been followed (*Id.* at 477), the judge may, if he then finds himself unable to make the requisite findings of §77(e), either dismiss the proceeding or refer the matter back to the Commission with the evidence which he received bearing upon the manner in which the Commission carried out its function (§77(e), second paragraph).

These respective functions are "intertwined" not only by reason of the special background of the Commission[8] and the public policy objectives of the statute, but in recognition of the need for judicial rather than administrative expertise in carrying out the requirement of §77(e) that no plan be approved unless the reorganization court finds it to be "fair and equitable." There is no suggestion in §77(e) or elsewhere that a reorganization court must adopt the Commission's finding as to fairness and equity merely upon being satisfied that there was substantial evidence to support it. It seems clear that the statute demands an unencumbered, independent determination by the judge of fairness and equity. These are words of art in bankruptcy law. *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 115(1939). The burden of this finding should not be permitted to be avoided by the judge on the ground that

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[8] "... The Government has an agency that it depends upon and generally has depended upon to deal with a very difficult question, namely, the value of the property of these common carriers" (P.C. Br. 3b, quoting from legislative history).

the Commission's determination of a similar nature was supported by substantial evidence. Under circumstances where it is brought to the judge's attention that the evidence before the Commission could be refuted by other evidence that was not presented to the Commission, he should not be permitted to rely upon the substantial evidence rule in making the affirmative findings that are required of him (*cf. U.S.* v. *Bianchi, supra,* at 715). To hold otherwise would mean that an entire universe of claimants, required to submit their claims to the reorganization court,[9] would be deemed bound by a proceeding before the Commission in which their "claims for equitable treatment" (§77(e), second sentence) might never even have been considered.

2. THE REORGANIZATION COURT PROPERLY CARRIED OUT THE REVIEW FUNCTIONS ASSIGNED TO IT BY THE *ECKER* CASE.

Under the *Ecker* case, the Reorganization Court is required to be satisfied that the statutory requirements of §77(e) were met by the Commission in making its valuation. These standards are set forth in the last paragraph of §77(e). The valuation of "any property used in railroad operation" is required to be determined basically on its earning power and "all other relevant facts."[10]

In the present case, however, there was no earning power. As the Commission found (App. 45a): "If there is one thing on this record that is clear and undeniable, it is that NH has neither earning power nor the prospect of earning power." Accordingly, the statutory standards to be reviewed by the Reorganization Court pursuant to the

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[9] See, for example, §§77(c)(4), 77(c)(5), 77(c)(7), 77(c)(8), 77(c)(9), 77(c)(10) and 77(c)(13).

[10] Reproduction cost new and less depreciation, original cost and actual investment are to be given effect only "in light of its earning power and all other relevant facts" (§77(e), last sentence).

Ecker case are those which may properly be deemed to be within the ambit of the phrase "all other relevant facts."

All parties are in agreement that liquidation value is the only appropriate method of valuation for the New Haven's property under both §77 and §5(2). The government has also specifically recognized that the so-called "abandonment delay" and "bulk sale" discounts, aggregating over $22 million, which the Reorganization Court refused to countenance, should be considered part of the valuation concept embodied in a determination of liquidation value. The government recognizes this in stating that, unlike the Reorganization Court, "the three-judge court took what we consider a better approach: It declined to view net liquidation value as a rigid concept and acknowledged the propriety of the Commission's reconsideration of what should go into that concept" (U.S. Br. 30).

Upon the government's own analysis, accordingly, these discounts were a part of the statutory standards to be weighed by the Reorganization Court. The government is wrong, however, in its characterization of the position of the Reorganization Court; it was the *application* of the concepts that was rejected by the Reorganization Court and not the right of the Commission to consider what should enter into the valuation concept. It was wholly within the direction given to it in the *Ecker* case that the Reorganization Court concluded that the Commission was wrong in its analysis of applicable case and constitutional law, and that "neither the hypothetical concept nor the actual case" required the result reached by the Commission (App. 292a). The Reorganization Court considered and rejected the two discounts not only from the standpoint of the sufficiency of evidence upon which the Commission found the amounts, but also upon the conceptual basis of whether the Commission could properly employ these two discounts in making a determination of net liquidation value under §77(e).

Clearly, liquidation value is the proper standard. To be sure, the government continues to assert that the Commission was correct that liquidation value is not necessarily a constitutionally required minimum (U.S. Br. 31n). It argues that if the New Haven could be reorganized to produce $1,000,000 of income available for fixed charges, the Commission could have valued the New Haven by capitalizing that income under §77(e). It then argues that under such circumstances an abandonment would not be permitted and the presumably higher liquidation value would not be required to be paid. However, even if it is assumed, *arguendo*, that a carrier may be constitutionally required to operate notwithstanding a failure to receive a fair return on investment, the government's position is conceptually untenable. When it is assumed that there is net income available for fixed charges, there is no longer the need for the "forced" inclusion which occurred in the present case, and a voluntary inclusion would leave the New Haven, as held in the *St. Joe* case, *supra*, the right to reject price and inclusion and to insist upon traffic protection as a remedy. *Cf. Baltimore & Ohio Railroad Co.* v. *United States*, 386 U.S. 372 (1967). Penn Central agrees that it is required to pay liquidation value as the fair measure, its disagreement being not in basic concept but in its application and the amounts which it is argued are required to satisfy it. Unlike the government, Penn Central has never suggested that it should pay less for a railroad having net income than it would for the same railroad operating at a staggering deficit.

Apart from the two discounts from liquidation value premised upon the Commission's hypothesis of an abandonment proceeding and a "bulk sale" condition to the abandonment certificate which it would issue after a one-year delay, there are two other valuation disagreements between the Reorganization Court and the Commission. One of these is the disagreement of the Reorganization Court with the Commission's basis for rejecting the higher of Witness McCann's two valuations for the Bronx Yards.

As previously noted, the Court provided in *Ecker* that, in addition to satisfying itself that the statutory requirements have been met, the Reorganization Court must also be satisfied that the Commission's determination of value is supported by "material evidence." The nub of the disagreement on the Bronx Yards was not a refusal to accept the Commission's appraisal of what could fairly be deemed to be evidence, but an unwillingness to accept the Commission's opinion in the absence of any evidence.

The remaining area of disagreement involves a question of correctness of computation by the Commission of the discount to present worth of liquidation receipts and expenses. The government and Penn Central take the position that the Bondholders are, in effect, too late for the game in raising this issue, citing *United States* v. *L. A. Tucker Truck Lines*, 344 U.S. 33 (1952). Whatever may be the weight of the *Tucker* case in a conventional review by an appellate court of the findings of an administrative agency, it is submitted that it is not applicable to a "hearing" before a reorganization court under §77(e).

3. THERE IS NO LEGAL OR POLICY REASON THAT REQUIRES AN IDENTICAL SCOPE OF REVIEW FOR COMMISSION ORDERS ENTERED UNDER BOTH THE BANKRUPTCY ACT AND THE INTERSTATE COMMERCE ACT.

One of the procedural problems of the instant case has been that the issues determined by the Commission were subject to two distinct review procedures. As the government has noted, the United States itself moved to dismiss the Three-Judge Court's review of the Second Supplemental Report on the ground that the Reorganization Court had exclusive jurisdiction (U.S. Br. 13n). In denying that motion, the Three-Judge Court noted that notwithstanding the "duplicitous system of review," it could not properly decline to exercise the jurisdiction conferred upon it (App.

325a-326a). In the opinion of the Three-Judge Court now being reviewed, it was stated (App. 431a):

> "Essentially, we think our disagreements with Judge Anderson and Judge Weinfeld reflect a difference in view concerning how far we are at liberty to substitute our own notions for the decisions the Commission has taken."

This apparent dilemma is not the significant issue that it appears to be. Even if it is assumed, *arguendo*, that the Three-Judge Court correctly carried out its responsibility within the framework of function assigned to it, there still need be no dilemma, insofar as the decision of the Reorganization Court is concerned. It is submitted that the Three-Judge Court could have properly determined, as a matter of its function, that it was satisfied that the Commission's findings were supported by substantial evidence, and, at the same time, the Reorganization Court could properly have reached an opposite result on the merits in carrying out the functions prescribed for it by the *Ecker* case.

The real dilemma is not how the two courts could arrive at conflicting results but whether the Commission is now bound to reach the same result under each of the statutes. This dilemma must be considered in light of the Commission's indication that if, in fact, it would be required under §77(e) to value the New Haven's properties in the manner indicated by the Reorganization Court, it might not be able to require the inclusion of those properties at that price in the Penn Central system. The ostensible reason is that the resulting price might constitute an undue burden upon Penn Central from the standpoint of public interest in the proper functioning of the Penn Central transportation system (App. 162a). Assuming, *arguendo*, that the Commission might, therefore, not have required inclusion, the New Haven estate would be receiving in liquidation the full liquidation value found by the Reorganization Court under

§77(e). If the only reason why the New Haven estate should not be permitted to receive that full value is the assumed undue burden on Penn Central,[11] then it must follow that the public interest is not entitled to demand the liquidation discount which the Commission has attempted to impose. If the public interest, in fact, requires the properties of the New Haven to be part of the Penn Central system and not abandoned, it must constitutionally require that a price be paid which is the minimum which could otherwise be received by the estate in a liquidation sale under §77 of the Bankruptcy Act, without any consideration of the hypothetical consequences of an abandonment. If the Reorganization Court is correct, as we submit it is, that the liquidation value of the property may not fairly be discounted for the hypothesized abandonment delay and a bulk sale conditioned upon the right to abandon, then the Commission must logically find under the "basic propositions of law" it has espoused that what is "fair and equitable" under §77(e) is "just and reasonable" and "equitable" under §5(2) (U.S. Br. 26).

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[11]The Commission has stated that "it is inequitable to conceive at the same time both a right in the bondholders to break up the NH and an obligation on Penn Central to keep it going" (App. 141a).

CONCLUSION

The Trustee submits that, for the reasons stated herein and in his main brief, the Reorganization Court's findings as to the Commission's legal errors should be sustained and the case returned to the Commission with instructions to modify its findings in accordance therewith for purposes of its orders in the premises under §5 of the Interstate Commerce Act and §77 of the Bankruptcy Act.

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